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A Two-Part Report: A and B

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Investment In Japan Booming

Add a chapter on domestic investment to the story of Japan's surprisingly strong economic growth in the past year. Consumer spending and government expenditures have received well-deserved credit for helping Japan to overcome the weakness in its export markets and the influx in imports that are two consequences of the appreciating currency. But neither of these factors grew as fast in fiscal year 1987, which ended March 31, as private fixed non-residential investment. This category was up 10.1 percent in price-adjusted terms for the year and accounted for 1.9 percentage points of the 4.9 percent rise in real gross national product. Put another way, 19.6 percent of the economy contributed 38.3 percent of the economy's growth in FY 1987.

As a factor in economic expansion, such investment is a gift that keeps on giving. Increased demand for goods and services pushes the economy forward when the investment occurs. Later, when plant and equipment come on line, the ability to produce goods and services increases, providing another benefit.

Few would dispute that the willingness of Japanese firms to put funds into new investment has been an important factor in the country's remarkable postwar record of superior economic performance. Seen in this light, the recent figures -- which by some measures are record highs -- are even more remarkable. While investment as a percentage of real GNP dipped from 18.8 percent in FY 1970 to 14.1 percent in FY 1977, it has been climbing again in the past few years. By January-March 1988 the rate reached 20 percent, surpassing a previous peak of 18.9 percent achieved in the second quarter of 1970.

In recent years firms have been able to buy investment goods relatively inexpensively. This is reflected in Japan's GNP data, which show an almost constant ratio of fixed non-residential private investment to GNP between FY 1980 and FY 1987 if measured in nominal terms but a rising one if measured in real yen (see Table). The falling relative cost of investment goods may have contributed to the relative increase in real investment. The increase in the real figure means that investment has been growing faster than GNP, but the stability of the nominal figure suggests that increased investment has not been coming at the expense of other kinds of spending and investment.

Japanese Private Fixed Non-Residential Investment

Fiscal Year	Nominal Investment/ Nominal GNP	Real Investment/ Real GNP*
1970	20.8%	18.8%
1975	18.0	18.1
1980	15.7	15.8
1981	16.0	16.4
1982	15.0	15.8
1983	14.3	15.0
1984	13.5	14.9
1985	13.5	15.1
1986	13.1	15.7
1987	13.5	16.8

* 1980 prices

Source: Economic Planning Agency

Investment in plant and equipment in FY 1987 got a boost from the economic expansion that began in late 1986. In the initial stages of recovery, firms use their existing capacity more fully. As the expansion continues, they find they have to build new capacity. That is happening now. Low interest rates in FY 1987 also contributed to making investment more attractive.

None of these figures takes into account the well-publicized expansion of Japanese firms abroad. While eventually such expansion may come at the expense of capacity growth in Japan, it has not so far. On the contrary, the data suggest that Japanese firms are strongly committed to production at home.

The Bank of Japan estimates that, for the manufacturing sector, direct investment overseas came to 3.3 percent of domestic fixed investment in FY 1986 and 4.7 percent in the first half of FY 1987.

Investment is likely to be even stronger in FY 1988 than in FY 1987. A widely watched predictor of investment intentions, machinery orders from the private sector (excluding shipbuilding and electric power), has been bullish. For the nine months through June, every month has shown year-to-year increases in double digits, with June coming in with a 23.5 percent increase. Consistent with this, NRI & NCC Co., Ltd. forecasts that real private fixed investment in FY 1988 will increase another 12.1 percent on top of FY 1987's 10.1 percent expansion. If its calculations are correct, the 2.4 percentage point contribution to overall GNP growth will be almost half the total of 4.9 percent real economic growth expected for the year.

In FY 1988 a new positive factor may come into play. During the boom years of the 1960s and the early 1970s, the average age of Japan's corporate facilities dropped rapidly as firms expanded their productive capacity. At the end of 1973 manufacturing facilities were 6.6 years old on average, according to the Economic Planning Agency. This was down from 8.8 years at the end of 1967. With the start of slower economic growth in the late 1970s, however, Japan's plant and equipment began to age, with the average creeping back to 8.8 years by the end of 1987. Eventually, wear and tear and advancing technology dictate replacement. That process may accelerate in FY 1988. The Ministry of International Trade and Industry predicts that "renewal investment" is expected to rise a nominal 13.9 percent in FY 1988 after dropping about 8 percent in FY 1987.

However, the high levels of investment in Japan may not have the same effect on future aggregate economic growth as they have had in the past. The Economic Planning Agency believes that the economy will be getting less bang for its buck (or yen). In its calculations using a capital coefficient that relates investment to increased production levels, EPA argues that, yen for yen, investment in the nonmanufacturing sector produces less effect than it does in the manufacturing sector; furthermore, the coefficient is becoming less favorable for nonmanufacturers while remaining stable for manufacturers. Since nonmanufacturing accounts for an ever larger share of the whole economy, the result is to make the economy-wide coefficient less favorable, suggesting investment will do less to increase the capacity of the economy than previously.

But this is a long-term problem, if that. The Bank of Japan is worried that manufacturing investment currently looks too strong. Its February forecast of manufacturing investment predicted a nominal 18.6 percent hike in FY 1988. However, this figure is close to the 20 percent level that the bank has warned could trigger inflationary pressures through the increase in demand for capital goods. The bank also worries that, once new investment is in place, there will be excess capacity. Better to postpone some investment to 1989, the bank says, and avoid these problems.

U.S. firms will be very interested in seeing whether Japan's manufacturing firms will heed the bank's warning, and what will happen if they do not. With Japanese manufacturers doing more than 95 percent of their investing at home, U.S. companies realize that competition from goods produced at least

partly in Japan will remain important, the increase in Japanese direct investment in the United States and elsewhere notwithstanding.

Douglas Ostrom

Prefectural Politics Complicate Tax Debate

Much more will be at stake in the September 4 by-election in Fukushima prefecture than the governorship and an upper house seat. The aftershocks of this election could affect passage of controversial tax reform legislation as well as the ruling Liberal Democratic Party's influence in the Diet, LDP secretary general Shintaro Abe's control of the party and Noboru Takeshita's grip on the prime ministership. All this could happen because two LDP members insisted on squaring off against each other for the governorship.

A local factional feud evidently compelled former construction ministry bureaucrat Toshio Hirose and upper house member and finance vice minister Eisaku Sato to openly defy Tokyo and throw their hats into the ring. At first, the party leadership urged Mr. Sato not to seek the governorship since he would need to resign his upper house Diet seat; that, in turn, would necessitate a by-election to replace him and, it was feared, allow the opposition parties another shot at weakening LDP dominance in the parliament. Ignoring this counsel, Mr. Sato decided to run as an independent. The LDP then threw its support behind Mr. Hirose.

In an apparent attempt to broaden his support, however, Mr. Hirose cut a deal with the Japan Socialist Party to oppose the prime minister's consumption tax proposal in return for JSP backing. He will also run as an independent candidate but with joint support from the local LDP and JSP chapters. Mr. Hirose enjoys such strong support at the grass roots that the local LDP chapter has refused to cancel its endorsement despite Tokyo's objections. The former government bureaucrat told an August 10 press conference that he reached a five-point policy agreement with JSP because he felt obliged to take into account "the opinions of all voters" on the tax issue. (JSP reportedly controls approximately 200,000 votes in Fukushima.)

The Hirose defection prompted the Sato campaign to demand that the LDP leadership withdraw its support for the former government bureaucrat. Prime Minister Takeshita immediately expressed his displeasure with Mr. Hirose's action. Reinforcing the prime minister's disavowal, Mr. Abe stated that "the LDP can never support a candidate who expresses outright opposition to the consumption tax . . . [which is] the biggest political task of the Takeshita cabinet." In the sometimes capricious style of Japanese politics, the ruling party has since switched its support to Mr. Sato.

What has heightened LDP concerns about this prefectural race is a fear that this may become "another Iwate." The JSP won a by-election race in Iwate prefecture in March 1987 -- a victory that political pundits contend led to the defeat of then Prime Minister Yasuhiro Nakasone's sales tax proposal. Thus, the ruling party leadership is concerned that a Hirose victory in Fukushima would lend credence to the anti-tax arguments espoused by the opposition parties and undermine the already shaky base of public support for the consumption

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1986	1987	January-June 1987	January-June 1988	April 1988	May 1988	June 1988
Japan's Balance of Payments							
Trade Balance	$92,827	$96,386	$48,411	$43,492*	$8,485*	$6,606*	$7,380*
Exports (f.o.b.)	205,591	224,605	106,338	122,754*	21,941*	20,061*	21,407*
Imports (f.o.b.)	112,764	128,219	57,927	79,262*	13,456*	13,455*	14,027*
Current Account Balance	85,845	87,015	43,724	37,754*	7,115*	5,792*	6,426*
Long-Term Capital (net)	-131,461	-136,532	-76,574	-51,495*	-10,107*	-16,245*	-10,001*
Overall Balance	-44,767	-29,545	-19,329	-11,009	-3,525	-7,314	-8,864
International Reserves (end of period)	42,239	81,479	69,273	87,700	86,838	87,244	87,700
Japan's Customs Clearance Trade							
Trade Balance	82,743	79,706	40,038	33,650	6,766	5,167	5,919
Exports (f.o.b.)	209,151	229,221	108,395	125,480	22,478	20,650	22,056
Cars	32,945	35,693	17,026	18,787	3,542	3,191	3,073
Steel	12,706	12,610	5,865	7,034	1,177	1,219	1,347
Imports (c.i.f.)	126,408	149,515	68,357	91,830	15,712	15,483	16,137
Crude Oil	19,481	20,663	10,057	10,522	1,706	1,488	1,585
Manufactured Products	52,781	65,961	29,507	44,144	7,843	7,530	7,773
Japan-U.S. Trade							
Trade Balance	51,401	52,090	24,641	20,930	4,131	3,401	3,625
Exports (f.o.b.)	80,456	83,580	39,190	41,468	7,351	6,907	7,350
Imports (c.i.f.)	29,054	31,491	14,549	20,538	3,220	3,506	3,725
Yen-Dollar Exchange Rate (average for period)	Y168.52	Y144.64	Y147.92	Y126.81	Y124.93	Y124.77	Y127.14
U.S. Trade							
Trade Balance	-155,137	-170,320	-84,453	-66,385	-9,891	-9,514	-12,624
Exports (f.a.s.)	227,159	254,122	119,672	158,097	26,218	28,143	27,385
Imports (c.i.f.)	382,295	424,442	204,125	224,482	36,109	37,657	40,008
U.S.-Japan Trade							
Trade Balance	-58,575	-59,825	-29,737	-25,974	-4,436	-4,116	-4,399
Exports (f.a.s.)	26,882	28,249	12,574	18,202	3,016	2,932	3,417
Imports (c.i.f.)	85,457	88,074	42,311	44,174	7,452	7,049	7,816

*Preliminary

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1986	1987	January-June 1987	January-June 1988	April 1988	May 1988	June 1988
Discount Rate (end of period)	3.0%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Outstanding Money Supply	8.7%	10.4%	9.4%	11.7%	11.3%	11.4%	11.1%
Industrial Production	-0.2%	3.4%	0.5%	10.4%	11.0%	10.2%	9.7%
Manufacturing Operating Rate	-4.6%	0.1%	-3.3%	6.4%	4.9%	6.2%	6.4%
Number of Bankruptcies	-7.1%	-27.6%	-23.1%	-20.4%	-13.7%	-20.1%	-19.0%
Residential Construction Starts	10.4%	-22.7%	18.6%	8.8%	2.0%	4.2%	1.9%
Job Openings to Applications (ratio)	0.62	0.70	0.64	0.94	0.94	0.99	1.05
Nominal Wages	2.7%	1.9%	1.9%	3.0%	3.4%	3.6%	4.4%
Labor Productivity	1.9%	5.8%	1.7%*	12.5%*	12.6%	n.a.	n.a.
Wholesale Prices	-9.1%	-3.7%	-6.5%	-0.8%	-0.7%	-0.5%	-0.6%
Consumer Prices	0.6%	0.1%	-0.4%	0.5%	0.3%	0.2%	0.2%
Yen-Based Export Prices	-15.1%	-5.1%	-7.0%	-3.8%	-2.3%	-1.4%	-2.5%
Yen-Based Import Prices	-35.8%	-8.3%	-19.5%	-3.4%	-3.0%	-2.8%	-2.9%

*Through April of each year only.

For Japan's most recent GNP figures, see JEI Report No. 24B, June 24, 1988.

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JEI

REPORT

A Two-Part Report: A and B

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JAPAN'S ROLE AS AN INTERNATIONAL CREDITOR

Summary

Even as Japan's current account surplus first mushroomed, then resisted the constricting effects of exchange rate changes, Japan's overseas investments grew apace. In fact, mathematically, current account surplus and net capital outflow are opposite sides of the same coin, both depending in part on Japanese saving and spending behavior. Japanese financial firms have taken advantage of their role as transmission belts for Japan's capital outflows to establish themselves in overseas financial markets. Even if Japan's current account surplus declines or disappears, the financial firms are likely to remain in those markets. Japan's overseas presence and Tokyo's new role as a major financial center add new dimensions to international financial markets already rapidly changing as a result of deregulation, liberalized capital flows and new technology.

Overview

When Japanese financiers talk, the world listens. Real estate agents attempting to sell their landmark commercial properties in large urban areas have to consider Japanese firms both as potential buyers and as factors in the broader economic environment. If Japanese companies were to become reluctant about buying U.S. Treasury securities, the fewer number of buyers would pull up yields on financial instruments across the board, including interest rates on home mortgages, at least temporarily. On the other hand, the willingness of Japanese banks, life insurance companies and industrial firms to keep investing in the United States has so far kept interest rates lower than otherwise and certainly encouraged a larger level of investment in the United States than

would otherwise be possible. Ironically, U.S. rivals of Japanese industrial firms are among the beneficiaries, directly or indirectly getting affordable funds for the investments required to mount a counterattack. Still, one year after the worldwide collapse of stock markets underscored the interdependence of financial markets, Japanese investment has created a sense of vulnerability among some Americans and led to calls for another look at Japan's rapidly expanding presence in world financial markets and particularly at its sharply increased direct foreign investments.

Why Japanese Foreign Investment Is So High

Outbound capital flows are inextricably linked to the savings rate, domestic investment and government spending decisions. Other things equal, higher household savings make more funds available to invest domestically, to finance the government deficit, and to invest overseas. The lower the level of domestic investment and the smaller the government budget deficit, the larger the amount available for overseas capital flows, provided other factors remain constant.

Table 1 compares the savings-investment relationship in the United States and Japan. The Japanese household sector, reflecting its high savings rate, has had a large surplus for lending to business, government and foreign borrowers. American households, reflecting a much lower savings rate, have had much less for these purposes. In addition, the budget deficit as a percentage of gross national product has been lower in Japan than in the United States since 1983. The relatively smaller savings shortfall among U.S. non-financial corporations has not been enough to offset the household and government factors; as a consequence the sectoral financial balance of non-residents with the

Table 1: Sectoral Financial Balances in Japan and the United States

(as percent of GNP)

	1980-85	1985	1987
United States			
Public Sector	-3.4%	-5.2%	-3.8%
Non-residents	-0.4	-3.0	-3.3
Non-financial Corporations	-0.7	-0.5	-0.3
Households	4.5	4.7	3.4
Japan			
Public Sector	-4.4	-4.0	-2.4
Non-residents	-0.4	-2.1	0.6
Non-financial Corporations	-0.8	-2.3	-2.2
Households	5.6	8.4	4.0

Notes: For Japan the public sector includes public enterprises. The 1987 figures are BIS estimates.

Source: Bank for International Settlements, Fifty-Eighth Annual Report.

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United States has been positive in recent years (capital inflow) and negative with Japan (capital outflow). Simply put, the high savings rate in Japan has permitted, simultaneously, a public-sector deficit, high investment levels and capital outflows. Loosened restrictions on capital outflows have resulted in an increased percentage of investment funds being channeled overseas.

Japan's position is hardly unique. Bank for International Settlements data calculated on the same basis as those in Table 1 show that West Germany's public-sector deficit, household surplus and surplus with respect to non-residents are all much closer to Japan's than to this country's.

Japan's Changing International Position

Japan is the world's largest creditor -- meaning that its foreign assets exceed its liabilities by the largest margin -- but its role is of very recent vintage. Even after it became a world economic power in the 1970s, its position as an international investor was a modest one at best. In fact, the private sector was a net debtor as recently as 1981. The mirror image of Japan's rise has been the decline of the United States. The world's largest creditor as recently as 1982, by 1987 America was the largest debtor (see Table 2).

Table 2: Net International Investment Positions of Japan and the United States

(In billions of dollars at yearend)

	United States	Japan
1969	$37.0	$13.9
1970	47.9	13.0
1971	58.7	8.9
1972	74.2	7.0
1973	61.6	9.6
1974	22.7	22.0
1975	26.1	26.2
1976	34.3	28.6
1977	206.3	11.5
1978	141.5	10.9
1979	126.9	24.7
1980	84.5	37.3
1981	3.5	74.3
1985	-110.7	129.8
1986	-269.2	180.4
1987	-368.2*	240.7

*Preliminary

Note: Official figures overstate the extent of U.S. foreign indebtedness, since U.S. gold stocks are valued at a small fraction of their market price, and U.S. investments abroad are listed at book value rather than higher market value.

Source: Department of Commerce and Bank of Japan

America's role is the more unusual one. Most industrialized nations are net creditors, with developing countries on balance being net debtors. For example, the U.S. Department of Commerce estimated that for 1987 West Germany's net creditor position was $165 billion and the United Kingdom's was $160 billion. Canada, however, was an even larger net debtor relative to its GNP than the United States at $175 billion, according to the Commerce estimates.

Tables 3 and 4 show the breakdown of Japan's net foreign assets. Until 1984 the government accounted for most of its net foreign position. During the 1970s and the 1980s Japan took several measures to liberalize international capital flows, the most important of which was the Foreign Exchange and Foreign Trade Control Law of 1980, which made free international capital flows the rule rather than the exception. The 1984 yen-dollar accord with the United States accelerated the pace of liberalization. For example, recent steps taken under that measure to breathe life into the Euroyen market have had the effect of swelling the issue of Euroyen bonds by Japanese corporations. A Euroyen bond is a yen-denominated bond issued outside the Japanese bond market by a resident or non-resident of Japan. Such bonds issued by residents, which amount to a capital inflow into Japan, are reflected in Table 5 under external bonds. (Table 5, which describes investment flows, is not comparable to Tables 3 and 4, which describe investment stocks and contain valuation adjustments not reflected in Table 5.)

Most Japanese private long-term investment continues to be in securities, despite the publicity concerning direct investment in manufacturing facilities, distribution and real estate. Within securities, bonds are more important than stock, even though at $16.9 billion the Japanese were the largest net purchasers of foreign equities in 1987, replacing the British who became net sellers. At the end of 1986, the latest year for which comparable data are available, the foreign stock holdings of Japanese investors at $13 billion were still far behind the British, who had $123.5 billion, and the Americans, who had $61 billion.

Not surprisingly, considering its debtor status and volume of trade with Japan, the United States has received a substantial portion of Japan's overseas investment funds, although there have been substantial year-to-year variations (Table 6). The high percentage accounted for by Luxembourg reflects its status as a center for Eurobond activity. The Securities Dealers Association of Japan puts long-term securities investments in the United States in 1986 at approximately 98 percent in bonds of all types and 2 percent in stocks, with a 93-7 percent split last year. The heavy emphasis on U.S. bonds is one reason Japanese intentions in the U.S. Treasury bond market are so closely watched. At a recent Treasury auction, Japanese buyers reportedly accounted for, depending on the maturity, between 20 and 40 percent of the successful bidders (see, for example, JEI Report No. 21B, May 7, 1988). The actual dependence of the U.S. Treasury on Japanese buyers is hard to gauge. Soon after their successful bids, Japanese investors sell a portion on the secondary market. The heavy volume on the secondary market, where Japanese investors are a smaller percentage of the total, and the high degree of substitutability among Treasury notes and bonds and other long-term instruments suggest that these figures overstate the real importance of Japanese investors in the U.S. bond market as a whole.

Table 3: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1971	$-7,088	$16,861	$9,773
1972	-6,820	20,687	13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744

Source: Bank of Japan, Balance of Payments Monthly, April 1988.

Table 4: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1986	End of 1987	End of 1986	End of 1987
Long-Term	$476,136	$646,181	$192,336	$236,181
Private Sector	424,704	565,100	152,192	178,810
Direct Investments	58,071	77,022	6,514	9,018
Trade Credits	31,992	37,189	33	35
Loans	69,211	97,469	1,199	1,101
Securities	257,933	339,677	143,611	166,206
Others	7,497	13,743	835	2,450
Government Sector	51,432	81,081	40,144	57,371
Loans	33,558	43,145	66	47
Others	17,874	37,936	40,078	57,324
Short-Term	251,170	425,450	354,619	594,706
Private Sector	207,876	343,261	341,847	583,057
Monetary Movements	194,713	320,171	322,163	530,072
Others	13,163	23,090	19,684	52,985
Government Sector	43,294	82,189	12,772	11,649
Monetary Movements	43,294	82,175	7,103	3,922
Others	0	14	5,669	7,727
Total	727,306	1,071,631	546,955	830,887

Source: Bank of Japan, Balance of Payments Monthly, April 1988.

Table 5: Japan's Net Long-Term Capital Flows

(in millions of dollars)

	1986			1987		
	Outflows	Inflows	Net	Outflows	Inflows	Net
Direct Investments	$-14,480	$226	$-14,254	$-19,519	$1,165	$-18,354
Trade Credits	-1,836	-40	-1,876	-535	-1	-536
Loans	-9,281	-34	-9,315	-16,190	-119	-16,309
Securities	-101,977	545	-101,432	-87,757	-6,081	-93,838
Stocks	-7,048	-15,758	-22,806	-16,874	-42,835	-59,709
Bonds	-93,024	-2,109	-95,133	-72,885	6,675	-66,210
Yen-Denominated Bonds Issued in Japan	-1,905	n.a.	-1,905	2,002	n.a.	2,002
External Bonds*	n.a.	18,412	18,412	n.a.	30,079	30,079
Other	-4,521	-63	-4,584	-8,829	1,334	-7,495
Total	-132,095	634	-131,461	-132,830	-3,702	-136,532

*Bonds issued outside of Japan by Japanese institutions.

Note: For outflows, a minus (-) sign indicates an increase in Japanese assets abroad. For inflows, a plus (+) sign indicates an increase in Japanese liabilities to foreigners.

Source: Bank of Japan, Balance of Payments Monthly, April 1988.

Table 6: Japanese Investment in Long-Term Foreign Securities by Registered Nationality of Issuer

(percent of total)

	United States	Britain	West Germany	Luxembourg	Canada	Other	Total
1981	25.5%	22.6%	9.7%	23.4%	12.4%	6.6%	100.0%
1982	6.8	32.8	-1.5	26.6	1.5	33.5	100.0
1983	38.3	17.0	1.3	24.4	8.0	11.0	100.0
1984	42.4	14.1	-0.1	23.3	7.7	12.8	100.0
1985	56.4	11.2	0.8	21.1	4.1	6.5	100.0
1986	49.1	12.7	3.2	24.1	6.6	4.5	100.0
1987*	42.1	9.8	7.2	28.6	2.8	9.5	100.0

*January-September

Notes: Totals may not add due to rounding.
Figures do not include yen-denominated foreign bonds but do include foreign currency-denominated bonds issued on the Tokyo market.

Source: Ministry of Finance

Table 7 shows investment in foreign securities by investor. For the years shown, financial institutions have increased their share at the expense of others. In part, this reflects reduced restrictions on financial firms in how they can invest their money, but it also reflects decisions by non-financial firms to invest through tokkin (special money trust) and other indirect means.

Table 7: Japanese Investment in Foreign Securities by Type of Investor

(in billions of dollars)

	1983	1984	1985	1986	1987*
Commercial Banks	$1.8 (13.7%)	$4.5 (16.5%)	$12.6 (22.6%)	$23.1 (22.7%)	$24.8 (29.8%)
Trust Banks	1.5 (11.4%)	4.1 (15.2%)	12.8 (23.0%)	28.9 (28.3%)	17.3 (20.9%)
Insurance Companies	4.8 (36.9%)	6.4 (23.6%)	8.0 (14.4%)	20.7 (20.3%)	16.8 (20.3%)
Investment Trusts	0.3 (2.1%)	2.5 (9.1%)	3.3 (6.0%)	19.1 (18.7%)	10.0 (12.1%)
Others	4.2 (31.7%)	8.9 (32.8%)	16.8 (30.3%)	16.5 (16.2%)	15.0 (18.1%)
Securities Companies (own account)	0.5 (4.2%)	0.7 (2.8%)	2.0 (3.7%)	-6.4 (-6.2%)	-0.9 (-1.1%)
Total	13.1 (100.0%)	27.0 (100.0%)	55.6 (100.0%)	102.0 (100.0%)	83.0 (100.0%)

*January-September

Note: Some short-term securities transactions are included, making data not comparable to the relevant balance of payments statistics.

Source: Bank of Tokyo, based on Ministry of Finance and Japan Securities Dealers Association data.

Life insurance companies are a good example of how the loosening of restrictions has affected overseas financial activity. As the government has raised the percentage of the insurers' total assets that could be invested, foreign investment has soared. The continuation of another restriction has prevented the companies from making payments to policyholders out of capital gains. In response, the companies have concentrated on securities, especially bonds, where the periodic payment of interest accounts for most of the income. Not surprisingly, an estimated 50 percent of Japanese life insurance companies' holdings of foreign securities are in U.S. Treasury bonds.

The same capital gains provision has led to charges that the insurance companies have been playing havoc with certain American stocks that pay a high dividend, such as utility companies. The insurance firms buy the stock just in time to claim the dividend and then sell it even at the cost of a capital loss. Because more than one Japanese insurance company has been able to claim the dividend on a single share of an American company on the same day, trading in such stocks on the New York Stock Exchange has been remarkably heavy on the days in question, sometimes boosting the shares of otherwise unremarkable companies to the ranks of volume leaders. Japanese life insurance firms also use another device. They have set up subsidiaries, often in Luxembourg, for the express purpose of capturing capital gains income. The subsidiary then pays the parent a dividend.

New Trends in Foreign Investment

The relationship between savings, domestic investment and net foreign investment is a rigid one. But within that framework, the amount of foreign financial activity can vary greatly. The increase in these activities, especially in the context of a still large investment flow, has raised the foreign profile of Japanese financial firms considerably.

- Japanese institutions and others have become more active traders, buying and selling securities more frequently, increasing their impact on world financial markets even in the absence of an increased capital flow from Japan. The Bank of Tokyo notes that what it calls the net ratio of Japanese bond trading in overseas markets (the net value of securities divided by the traded value) has been declining, indicating more short-term trading. The ratio stood at 0.38 in 1983 but dropped to 0.03 in the first nine months of 1987.

- Private investors have at times changed their behavior, forcing the government to take action. In 1987 just this happened. Table 8 gives a sense of the recent role of the central bank. Negative values indicate outbound capital flows. In total, outbound flows of all types equal the current account surplus. In the first and second quarters of 1987, foreign short-term borrowing soared. The resultant decline in net outbound capital flows led the central bank to step in, reflected in the increase in the net official monetary position in foreign reserves. Japanese analysts suggest that the dramatic increase in short-term borrowing abroad reflects a hedge by Japanese firms wanting to invest abroad: they have moved toward having both sides of their balance sheet in the same currency during a period of unstable foreign exchange markets.

Table 9 amplifies on this explanation. While both nominal short- and long-term rates are lower in Japan than in the United States, the gap is much narrower for short-term securities. If dollar depreciation is anticipated, the short-term spread may be virtually meaningless from a Japanese borrower's perspective because it will be easily offset by the ability to pay in deflated dollars. The result would be a short-term capital inflow into Japan. The long-term spread, by contrast, may be enough to entice a flow of funds the other direction, exchange risk notwithstanding. If a single firm borrows short term in the United States and invests long term, it avoids most exchange risk, although, like domestic U.S. investors, the firm has to contend with other risks, such as the chance that short-term U.S. interest rates will rise, leading to losses. In short, Japanese financial service firms have increased their role as international financial intermediaries, evaluating interest rate differentials and exchange rate movements in an attempt to make a profit.

Table 8: Japan's Capital Account Transactions

(in billions of dollars)

	1985	1986	1987 Year	1987 I	1987 II	1987 III	1987 IV
Net Capital Flows							
Long-term Capital	$-64.5	$-131.5	$-136.5	$-32.2	$-44.3	$-22.0	$-38.0
Short-term Capital*	13.9	59.4	91.8	28.3	34.4	4.2	24.9
of which: Banks	10.8	58.5	71.8	21.9	27.2	-4.8	27.5
Nonbanks	-0.9	-1.6	23.9	1.4	6.5	9.8	6.2
Changes in Net Official Monetary Position	1.4	-13.7	-42.3	-17.0	-12.8	-3.4	-9.1
Equals: Current Account (with sign reversed)	49.2	85.8	87.0	21.0	22.8	21.2	22.1

*Including errors and omissions

Notes: Figures may not add due to rounding.
A minus (-) number indicates a capital outflow or an improvement in net official monetary position.

Source: Bank for International Settlements, Fifty-Eighth Annual Report, and Bank of Japan.

Table 9: Premium on Dollar Instruments*

		Short-Term	Long-Term
1985		1.00%	4.28%
1986		1.01	2.74
1987		1.90	4.17
1987:	I	1.47	3.21
	II	1.86	4.77
	III	2.30	4.05
	IV	1.98	4.65
1988:	I	1.88	4.37

*Interest rates in the United States less corresponding rates in Japan. The rates used for the United States are 10-year Treasury bonds and three-month Treasury bills; for Japan, long-term government bonds and three-month gensakis.

Source: Bank for International Settlements, Fifty-Eighth Annual Report.

The importance of Japanese banks as intermediaries is suggested by data from the Bank for International Settlements. Unlike the balance of payments data, which identify international transactions based on originating and receiving country, the BIS data identify transactions based on the home country of the originating and the receiving firm. Thus, purchases by the European subsidiaries of Japanese banks of securities issued by Japanese corporations in the Euromarket is a capital inflow into Japan according to the balance of payment statistics, but an increase in cross-border asset holdings of Japanese banks by the BIS criteria. By this measure, Japanese banks held 35 percent of all such assets in December 1987, far ahead of the 14.8 percent claimed by the runner-up, U.S. banks. The dominance of Japanese banks by this measure is consistent with their position as the world's largest in terms of assets.

• Activity in the United States real estate market illustrates yet another phenomenon: borrowing by foreign subsidiaries to finance purchases in the country that is host to the subsidiary, a transaction that might not get into international financial flows at all. The result can be considerable confusion. Commerce Department data based on the balance of payments framework put the increase in net U.S. real estate holdings by Japanese at a mere $1.5 billion in 1987. Private surveys appear to suggest that the amount is far more than that. A study by Salomon Brothers, Inc. puts the figure at $6.8 billion in 1987, up from $4.8 billion in 1986. In some contrast, Mitsubishi Bank, Ltd. estimates that worldwide Japanese real estate investment was $7.7 billion in Fiscal Year 1987 that ended March 31. The discrepancies could arise from U.S. sub- sidiaries of Japanese firms borrowing in dollars to finance their purchases, transactions that might not enter the balance of payments figures at all. In this sense, U.S. subsidiaries of Japanese firms are treated for data purposes exactly like purely domestic firms.

Several other developments suggest that Japanese firms are becoming increasingly integrated into the American financial services industry. As banks and securities houses become primary dealers of Treasury securities, they move into the inner sanctum of American financial life.

Banking is an activity where Japanese strategy apparently has less and less to do with facilitating capital flows. With their large presence in retail banking in California, Japanese banks want to be perceived as full participants in the American banking industry, not mere investment or trade appendages of their Tokyo parents (see JEI Report No. 3A, January 22, 1988). Insurance companies, noticeably slower off the mark than the banks, are also starting to show more interest in the American market for its own sake, rather than just as a location for investment in Treasury securities and in real estate. (See JEI Report No. 31A, August 12, 1988).

Finally, Japanese securities firms -- among the world's largest -- are here in full force. In addition to conventional securities trading, they are now venturing farther afield, becoming more active in options and futures trading. Yamaichi International (America), Inc., Daiwa Securities Co., Ltd. and Nikko Securities Co., Ltd. have been approved for clearing membership at either the Chicago Board of Trade or the Chicago Mercantile Exchange. In explaining his company's involvement, a Yamaichi executive said that Japan accounts for 25 percent of night trading volume on the CBT. In another area, Yamaichi, like Nomura Securities Co., Ltd., has purchased an interest in an American merger and acquisition specialist firm, possibibly signaling more extensive activity in this realm by Japanese companies (see JEI Report No. 30B, August 5, 1988).

The complexity of Japanese international financial activity outside the United States is increasing as well. Faced with restrictions on their activities in Japan, and finding the regulatory environment only slightly better in the United States, Japanese banks are turning to the Euromarket as a hospitable place to do business. Despite Japan's overall creditor status and its particular advantage explained above as a source for long-term funds, Japanese firms have still emerged as the biggest borrowers on international bond markets, located largely in Europe. According to the Bank for International Settlements, in 1987 Japanese firms borrowed $43.2 billion in the international bond market, surpassing runner-up United States, which borrowed $24.0 billion. The value of international bonds outstanding saw the United States with $163 billion compared with $150.7 billion for Japan.

Outlook

Japan's creditor position creates somewhat conflicting political and economic pressures.

- Decisions to limit overseas investment would affect not just foreign interest rates and equity prices but exchange rates, too. The reason is that, as Japan's foreign investment flows decline, the demand for dollars and other foreign currencies also drop, leading the dollar to fall and the yen to rise.

- As long as Japan has a current account surplus, net foreign assets will rise and investment income will tend to increase, in turn complicating the task of reducing the current account imbalance.

- While these factors might be expected to lead to a stronger yen than otherwise, Japan's foreign assets, to the extent they are denominated in dollars, lose value as the yen appreciates, creating an incentive to stabilize currency values. Furthermore, if investors come to expect instability in the foreign exchange market, they may become reluctant to increase their exposure in overseas currencies.

There is little doubt that being a large net creditor gives Japan more clout in world economic policy. Certainly, in an earlier era, the United Kingdom and the United States found that to be true. One area to watch in this regard is Third World debt. As latecomers, Japanese banks have far less exposure than U.S. banks, although their position is substantial (Table 10). The Federal Reserve Board puts the Third World debt of U.S. banks at $96 billion in 1988; the latest Minstry of Finance data for Japanese banks (1986) show $43.5 billion, up from $38.5 billion in 1985. However, the relatively good health and enormous size of Japanese banks will inevitably make them part of the solution. Building on recent initiatives, Prime Minister Noboru Takeshita proposed a Third World debt initiative at this year's Toronto economic summit of the free world's leading industrial nations that is indicative of a more activist Japanese stance.

As Japan's role in the world economy grows, so too does the use of its currency in international commerce. In 1987, 10.6 percent of Japan's imports were settled in yen, up from 2.4 percent in 1980 and 9.8 percent in 1986. According to the most recent International Monetary Fund data, 6.9 percent of international monetary reserves were in yen as of 1986, up from 1.5 percent in 1980. Some experts, among them Nobuyoshi Araki, economic advisor at the Long-Term Credit Bank of Japan, see the emergence of a yen bloc in East Asia.

Table 10: Third World Loan Exposure of Japan's Nationwide Commercial Banks

(in billions of yen as of March 31, 1988)

	Exposure	As Percent Of: Assets	Equity
Dai-Ichi Kangyo Bank, Ltd.	Y350.0	0.75%	36.6%
Sumitomo Bank, Ltd.	375.1	0.85	39.6
Fuji Bank, Ltd.	313.4	0.72	29.4
Mitsubishi Bank, Ltd.	339.7	0.80	35.0
Sanwa Bank, Ltd.	306.1	0.76	34.6
Tokai Bank, Ltd.	278.6	1.00	48.8
Mitsui Bank, Ltd.	198.4	0.77	37.5
Taiyo Kobe Bank, Ltd.	162.2	0.74	40.2
Daiwa Bank, Ltd.	88.8	0.68	27.1
Kyowa Bank, Ltd.	91.6	0.67	29.5
Saitama Bank, Ltd.	89.9	0.78	34.4
Hokkaido Takushoku Bank, Ltd.	100.0	1.06	52.4
Bank of Tokyo, Ltd.	671.2	3.21	146.5
Total	3,365.0	0.93	42.7

Source: Morgan Stanley & Co.

Of course, some see a threat in Japan's new financial position. While Japanese firms have argued that, as primary dealers, they will help the United States finance its trade and budget deficits, the Congress and the president may see things somewhat differently. As part of the omnibus trade bill passed this year and signed by the president, primary dealer status is to be tied to liberalization measures for domestic Japanese government securities. While many in the Administration and in Congress no doubt see the provision as a lever to open the Japanese market, others may see it as a way to limit, at least slightly, Japanese access to the U.S. market.

Conclusion

Reduced regulation, current account surpluses and large surpluses of savings over investment requirements have contributed to an explosion of international Japanese financial activity. There are signs that Japanese firms, no longer content to be conduits for Japanese funds flowing out of Japan to finance activities abroad, are becoming more active in overseas domestic financial markets and are even exploiting opportunities to raise funds abroad for use in Japan or elsewhere. Whether the Japanese come as borrowers or lenders, their multiplying presence is bringing local investors, stockbrokers and others to an accelerated awareness of Japanese financial power.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.